Internal Revenue Service

memorandum

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date: JUL 22 1988

to: Utility Industry Counsel CC:CLE

from: Director, Tax Litigation Division CC:TL

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subject: ACRS Losses on Mass Asset Accounts Absent Mass Asset Election Pursuant to I.R.C. section 168

This is in response to the request of the Utility Industry Specialist for technical advice regarding the proposed position of the Atlanta District on the disallowance of losses upon disposition of mass assets.

ISSUE

Whether the Service should take the position that taxpayers, who are using mass asset accounting principles for ACRS and ITC purposes but have failed to make the explicit mass asset election pursuant to Treas. Reg. § 1.168-5(e), in order to avoid the mass asset election provision for ordinary income recognition upon disposition in lieu of recognizing gain or loss, should be estopped from arguing that they have not made the mass asset election? Issue No. 0168-0800

CONCLUSION

A credible argument may be made that taxpayers have effectively made the mass asset election where mass asset accounting principles are consistently used and, therefore, taxpayers are estopped from claiming deductions or credits inconsistent with their use of mass asset accounting. An alternative position is also recommended.

FACTS

The general rules of ACRS under I.R.C. § 168 provide for the recognition of gain or loss on any ACRS asset in the year of disposition or retirement of that asset. An exception to the general rule is provided at section 168(d)(2)(A) for items

included in mass asset accounts. Mass assets are defined at Prop. Treas. Reg. § 1.168-2(h)(2) as follows:

> A mass or group of individual items of recovery property (i) not necessarily homogenous, (ii) each of which is minor in value relative to the total value of such mass or group, (iii) numerous in quantity, (iv) usually accounted for only on a total dollar or quantity basis, (v) with respect to which separate identification is impracticable, (vi) with the same present class life, and (vii) placed in service in the same taxable year.

A taxpayer may elect to account for mass assets in the same mass asset account, as though such assets were a single asset. If such treatment is elected, the taxpayer, upon disposition of an asset in the account, shall include as ordinary income all proceeds realized to the extent of the unadjusted basis in the account less any amounts previously so included. Prop. Treas. Reg. § 1.168-2(h)(1). Pursuant to Prop. Treas. Reg. § 1.168-5(e), the mass asset election is to be made on the income tax return for the taxable year in which the property is placed in service.

With respect to the investment tax credit, Treas. Reg. § 1.47-1(e)(4) contains the same definition of mass assets found at Prop. Treas. Reg. § 1.168-2(h)(2). The general rule for record-keeping for the investment tax credit requires taxpayers to maintain records sufficient to establish with respect to each item of section 38 property, the date the property is disposed of, the estimated useful life assigned to the property, the month and taxable year the property was placed in service and the basis or cost actually or reasonably determined of the property. These facts must be established from available records in order to compute any necessary recapture determination. Treas. Reg. § 1.47-1(e)(1). Regulations further provide that if, in the case of mass assets, it is impracticable for the taxpayer to maintain records from which he can establish the above-noted facts with respect to each item of property, and if he adopts other reasonable recordkeeping practices, he may substitute data from an appropriate mortality dispersion table.

The consistent and correlative treatment of mass asset accounts for purposes of ACRS and the investment tax credit is demonstrated by the following regulations. First, in the case of mass assets, the taxpayer may use a mortality dispersion table to determine estimated useful lives by assigning separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. Treas. Reg. § 1.46-3(e)(3)(iii). Furthermore, investment tax

credit recapture regulations provide that if in the case of mass assets placed in a multiple asset account, where general record-keeping is impracticable and required data is substituted from an appropriate mortality dispersion table, and if the depreciation rate for the account is based on the maximum expected life of the longest lived asset, in applying a mortality dispersion table, the average expected useful life of the mass assets in such account must be used. Treas. Reg. § 1.47-1(e)(2). In addition, several provisions of the ACRS proposed regulations are of particular relevance to the instant issue. Where basis has been reduced by 50% of the amount of the investment tax credit, and if as a result of early disposition of an asset in a mass account, the investment tax credit is recaptured, the basis of the account shall be increased by an amount equal to one-half of the recapture. For purposes of the requirement that proceeds upon disposition of mass assets are ordinary income, such increase in basis will be taken into account as unadjusted basis in determining the inclusion of proceeds as ordinary income. For purposes of determining the above-noted increase in basis upon disposition of an asset in a mass account, disposition of assets from a mass account shall be determined by the use of an appropriate mortality dispersion table. Prop. Treas. Reg. § 1.168-2(h)(4) and (5).

The following statements from the Senate Finance Committee Report regarding the Tax Reform Act of 1986 further demonstrate the interrelationship of the use of mass asset accounting and mortality dispersion tables:

> Under present law, taxpayers generally compute depreciation deductions on an asset-by-asset basis. Under regulations prescribed by the Secretary, there is an election to establish mass asset vintage accounts for assets in the same recovery class and placed in service in the same year. The definition of assets eligible for inclusion in mass asset accounts is limited, primarily because of concern about the mechanics of recapturing investment tax credit. ...
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> The bill continues the Secretary's regulatory authority to permit a taxpayer to maintain one or more mass asset accounts for any property in the same ACRS class and placed in service in the same year. As under present law, unless otherwise provided in regulations, the full amount of the proceeds realized on disposition of property from a mass asset account are to be treated as ordinary income (without reduction for the basis of the asset). ... The limitations on the ability to establish mass asset accounts under present law, as proposed in Treasury regulations, resulted, in part, from a concern about the mechanics of recapturing investment tax credits on dispositions

> of property from an account. To facilitate the application of the recapture rules without requiring that individual assets be identified, the proposed regulations provide mortality dispersion tables that cannot be applied easily to diverse assets.

Senate Finance Comm. Rep., No. 99-313, Tax Reform Act of 1986, (H.R. 3838) May 29, 1986.

The position paper prepared by the Atlanta District points out that most elections are advantageous to taxpayers. This is not totally true with the mass asset election of section 168. Although the election to use mass asset accounts relieves the taxpayer from the requirement to maintain detailed records on numerous, usually low dollar assets which are difficult to segregate by cost or basis, there is a quid pro quo attached. The taxpayer does not have to maintain individual records as required under the general rules for establishing cost or adjusted basis, but upon disposition of any asset, all proceeds are included as ordinary income.

The Atlanta District believes that by failing to make the section 168 mass asset election, taxpayers are avoiding the quid pro quo and are also failing to comply with the section 168 requirement of books and records adequate to determine cost and basis on individual assets. The District's position is that the taxpayer has elected mass asset accounting by placing assets in a single account and depreciating such account as a single asset. The District also believes that taxpayers are aware of the requirement for a mass asset election and are purposefully circumventing the requirement in bad faith.

In summary, based on the regulations discussed, there is an inconsistency between using mass asset accounting for ITC and mortality dispersion tables for ITC recapture and claiming ACRS losses upon disposition of assets, notwithstanding a failure to elect to establish mass asset accounts as provided in Prop. Treas. Reg. § 1.168-5(e).

Accordingly, we will analyze alternative positions that the Service should take upon audit in such situations. The first position is that when a taxpayer maintains a single account which includes more than one item for which no individual records are maintained for identification or basis purposes, the taxpayer has elected mass asset accounting and should be estopped from contending that he has not so elected. The taxpayer's election of mass asset accounting is demonstrated by the taxpayer's inability to identify an asset or its cost within the mass asset account, and by the taxpayer's determination of the number of items disposed of or the dollar value of dispositions through statistical methods such as averaging, historical experience or mortality dispersion tables. The essence of this position, of course, is that taxpayers in

substance use mass asset accounts but are claiming a non-mass asset accounting benefit of recognized losses upon disposition. Taxpayers use mortality dispersion tables for ITC recapture but avoid ordinary income treatment upon dispositions by not electing mass asset accounting. Furthermore, tax returns would be consistently filed claiming depreciation and ITC using mass asset accounting principles.

The alternative position would be to take the position that taxpayers have not elected mass asset accounting and disallow depreciation, the use of adjusted basis in calculating loss and disallow ITC due to no substantiation; i.e. where books and records are not maintained in a manner such that asset by asset cost or adjusted basis can be determined.

DISCUSSION

I. Taxpayers have Manifested a Choice to Use Mass Asset Accounting and should be Estopped from Using Inconsistent Accounting Methods

Taxpayers are not explicitly electing the use of mass asset accounting but are depreciating mass asset accounts and are claiming ITC and computing recapture upon dispositions by using mortality dispersion tables applicable to the use of mass asset accounting. Their use of mass asset principles thus avoids requirements for asset by asset recordkeeping, and their refusal to make the mass asset election avoids the requirement for ordinary income recognition upon dispositions, thus supposedly justifying claimed losses upon dispositions.

If most prior years are closed, the proposed primary position is that taxpayers have made the mass asset election by their consistent use of mass asset accounting principles. Their refusal to make the election is a bad faith effort to avoid the ordinary income recognition provision of mass asset accounting and they should be estopped from denying that they have made the election. The adjustment upon audit is denial of all claimed losses and ordinary income recognition for all proceeds.

The elements of the doctrine of equitable estoppel may be argued to support our position that taxpayers may not take inconsistent positions and thus avail themselves of the advantages of both positions. Equitable estoppel precludes a party from denying his own acts or representations which induced another to act to his detriment. The doctrine of estoppel is based upon the grounds of public policy, fair dealing, good faith and justice and is designed to aid the law in the administration of justice where without its aid injustice might result. The six elements of equitable estoppel according to the Tax Court are as follows:

1. Conduct constituting a representation of material fact;
2. Actual or imputed knowledge of such fact by the representor;

3. Ignorance of the fact by the representee;
4. Actual or imputed expectation by the representor that the representee will act in reliance upon the representation;
5. Actual reliance thereon; and
6. Detriment on the part of the representee.

Graff v. Commissioner, 74 T.C. 743, 761 (1980), aff'd per curiam, 673 F.2d 784 (5th Cir. 1982). See also Magnussen v. Commissioner, T.C.M. 1987-315.

We believe that all six of the above elements have been met by taxpayers filing tax returns claiming depreciation and ITC pursuant to mass asset accounting but failing to make the explicit mass asset election. It is axiomatic that tax returns are relied on by the Commissioner as complete and accurate, and taxpayers are held to the knowledge that their returns will be accepted as accurate and complete. It is our position that taxpayers' representations on their tax returns is a manifestation of the mass asset election. Furthermore, not holding taxpayers to a mass asset election would be detrimental to the Commissioner because of an inability to use mitigation to re-open closed taxable years in order to adjust ITC and depreciation computations which were based on the use of mass asset accounts. See infra.

In addition, we believe that taxpayers would be found to have met the elements of the doctrine of election as accepted by the Tax Court with respect to Federal tax law. This doctrine consists of the following two elements:

1. There must be a free choice between two or more alternatives, and
2. There must be an overt act by the taxpayer communicating the choice to the Commissioner, i.e., a manifestation of choice.

Grynberg v. Commissioner, 83 T.C. 255 (1984).

In Grynberg, taxpayers filed a return computing their charitable contribution deductions and carryovers using section 170(b)(1)(C)(iii) even though they had failed to attach to their return the narrative statement of election as required by regulations. In finding that a valid election had been made, the court listed the above two elements and indicated that a taxpayer will be held to an election which has been affirmatively made and where the benefits of the election are reflected on the return as filed. In applying the two requirements of the doctrine of election in Grynberg, the court found that taxpayers had a choice between two alternative methods of calculating deductions for contributions of appreciated capital gain property, and there was an overt act manifesting their choice to the Commissioner. Although they did not file the required statement of election, they affirmatively

manifested the election on their tax returns by applying the arithmetic of the section at issue to compute their charitable deduction. Similarly, with the instant issue, taxpayers have manifested a choice to use mass asset accounts through their depreciation and ITC computations on their tax returns.

Our position with respect to the consistency of taxpayers' use of mass asset accounts and their bad faith in not making a formal election is supported by Taylor v. Commissioner, 67 T.C. 1071 (1977), acq., 1979-2 C.B. 2. Taylor is a substantial compliance case, to be discussed infra, rather than an election doctrine case, but the court made some relevant points about the significance of consistency in accounting methods.

In Taylor, the issue was whether taxpayers had made an effective election where regulations set out specific requirements for making the election which were not followed. The regulatory election requirements in Taylor are essentially the same as those involved with the mass asset election. In both instances the election is made on the income tax return and specific information such as property identification and amounts must be provided. In both instances the election is binding unless consent to revocation is obtained from the Commissioner.

Taylor involved section 1251 in which gain from disposition of farm recapture property is ordinary income unless taxpayer elects the exception provided in section 1251(b)(4)(A). The section 1251(b)(4)(A) exception allows taxpayers to claim capital gain if they elect to follow the accounting methods specified in the exception. The required methods are to compute taxable income by using inventories and to charge to a capital account all expenditures paid or incurred. Like the mass asset election at issue herein, the election in Taylor, therefore, involved a quid pro quo. Taxpayers were required to elect to follow certain accounting conventions in order to receive the benefit of capital gain recognition conferred by section 1251(b)(4). As noted, there were specific procedural requirements for the election.

The Tax Court in Taylor, 67 T.C. at 1080, relied on the taxpayer's consistent use of the accounting methods at issue and noted that respondent was not prejudiced by taxpayer's actions. Similarly, a court could find that based on taxpayers' consistent use of mass asset accounting, they should be held to the quid pro quo of the election. Furthermore, failure to make the election is bad faith. Taxpayers are avoiding the election disadvantage but are taking advantage of mass asset accounting. The Commissioner would be prejudiced if he were unable to hold taxpayers to the substance of an election because otherwise an unwarranted advantage is gained by taxpayers.

We view the ordinary income exception as a logical restrictive feature of the reduced recordkeeping required of mass asset accounting. To allow taxpayers to claim losses but also use mass asset accounting is fundamentally inconsistent with mass asset accounting, whereby books and records need not substantiate basis of individual assets.

We also believe that because the failure to make the mass asset election is a means used to avoid the ordinary income treatment imposed by regulations, taxpayers should be estopped from denying a mass asset election, relying on the rationale of Gregory v. Helvering, 293 U.S. 465 (1935) in which the Supreme Court looked to the substance of a transaction when the form did not accurately reflect the substance. There was "an elaborate and devious form of conveyance masquerading as a corporate reorganization." Id at 470. The purported reorganization was not recognized because to hold otherwise "would be to exalt artiface above reality. ..." Id.

As a final point, to the extent that litigation hazards exist with respect to an estoppel argument, we believe such hazards are reduced by taxpayers' bad faith in avoiding making the election. Such bad faith supports the Service arguing that taxpayers' consistent use of mass asset accounting amounts to an election pursuant to the Tax Court's election doctrine. Not holding taxpayers to an election is prejudicial to the Service because it would allow taxpayers to take advantage of mass asset accounting while avoiding the quid pro quo. Furthermore, if taxpayers are not held to a mass asset election, it is likely that the mitigation provisions of sections 1311 et. seq. would not enable the Commissioner to re-open closed years to deny previously claimed mass asset treatment for ITC and ACRS. The inconsistency in taxpayers' positions is between related items but not identical items. The mitigation provisions involve inconsistent treatment of identical income or deduction items in different taxable years, i.e., double income or double deductions.

With respect to taxpayers' inconsistent accounting treatments, we also recommend taking the position that claiming losses upon dispositions is a change in method of accounting from the use of mass asset accounts to non-mass asset accounting treatment and is invalid absent the Commissioner's consent. Treas. Reg. § 1.446-1(e).

II. Alternative Position - Taxpayers Have Not Elected Mass Asset Accounting; Disallow Losses, Investment Tax Credit and Depreciation

The alternative position presupposes that most prior years in which investment tax credit was claimed are open. The recommended alternative position is that based upon the lack of a mass asset election for ACRS purposes, taxpayers may not use mass asset accounting. The use of mortality dispersion tables

to recapture I.T.C. upon dispositions is inconsistent with no mass asset election. Therefore, unless they can substantiate cost and adjusted basis by individual assets and identify individual assets, all losses, depreciation and investment tax credit should be disallowed for all open years.

This position does have numerous litigation risks. It is, of course, quite a hard line position. For one thing, we note that denying ITC will be difficult to sustain because, as discussed supra, there is no specific requirement for a mass asset election for ITC. Furthermore, we anticipate that taxpayers will argue substantial compliance with the mass asset election requirements. In our opinion, this argument presents substantial litigation hazards. There are cases to support an effective or implicit mass asset election by taxpayers because of substantial compliance with election requirements. If taxpayers are found to have made an effective election, we should argue in the alternative that they have ordinary income upon dispositions, not losses.

In Taylor, 67 T.C. at 1078-79, the court held that the taxpayer effectively made the election by using the accounting methods specified in the election and thus substantially complied with the election requirements. In the court's view, the use of the accounting methods specified in the election communicated taxpayer's intention to make the election. The essence of the election is capital gains treatment upon use of certain accounting methods; the election requirements themselves are merely directory. Id.

Similarly, we believe that Taylor supports a court holding that the use of mass asset accounting is what is essential to the election and ordinary income recognition is an inseparable corollary of such method whereby individual assets are not being tracked. The use of mass asset accounting is "effectively an election." Id.

The doctrine of an effective election was also applied by the Tax Court in American Air Filter Co. v. Commissioner, 81 T.C. 709 (1983). The issue involved elections under section 963 which were required to be filed with each year's tax return. The court noted, 81 T.C. at 719, that the Commissioner may insist upon full compliance with regulations when the regulatory requirements relate to the substance or essence of a statute but substantial compliance suffices when requirements are procedural and when essential statutory purposes have been fulfilled. The court found that taxpayer effectively elected to receive minimum distributions pursuant to section 963 where there was substantial compliance with the requirements to elect section 963. Taxpayer fulfilled the essential purpose of section 963; it received minimum distributions and included such amounts in income as required. Also at issue was whether taxpayer

effectively elected the 180-day distribution period provided in the regulations. The court found that taxpayer's treatment of the distributions was unequivocal and constituted an implicit election of the 180 day period. 81 T.C. at 724. In both of these cases, an election statement was not a prerequisite to substantial compliance. We believe a court could find that taxpayers have complied with the requirements of mass asset accounting and, therefore, have effectively elected such treatment through their unequivocal use of the method.

As discussed, the doctrine of substantial compliance with election requirements is premised on whether the requirements relate to the substance or essence of the statute or are merely procedural. If regulations are procedural in character rather than relating to the substance or essence of the statute, substantial as opposed to literal compliance will often be sufficient. The cases usually arise in the context of taxpayers arguing substantial compliance with election requirements so they may benefit from the election.

Substantial compliance with mere procedural requirements may be illustrated by Tipps v. Commissioner, 74 T.C. 458 (1980) and Sperapani v. Commissioner, 42 T.C. 308 (1964). In Tipps the issue was whether there was a valid election of the accelerated depreciation method. The election requires that ten categories of information be provided, and taxpayer failed to include one category of information. The court held that the missing information was a procedural or directory requirement. Similarly, in Sperapani, at issue was the validity of an election to have a sole proprietorship taxed as a domestic corporation pursuant to section 1361. Taxpayer had filed a statement of election, but the statement did not contain all the information specified in applicable regulations. The court held that the manner prescribed for making the election is directory, not mandatory, and taxpayer substantially complied with the essential provisions of the regulation. Holdings such as these are to be contrasted with cases in which the courts hold that the election requirements at issue relate to the substance or essence of the statute, and the taxpayers' assertions of substantial compliance are rejected.

At issue in Knight-Ridder Newspapers v. United States, 743 F.2d 781 (11th Cir. 1984) was the class life depreciation election. The election is made by filing Form 5006 or by providing certain specific information and by checking a box on Schedule G. Certain subsidiaries failed to comply with the election requirements, but the District Court held in taxpayer's favor on the basis that the taxpayer intended to use the class life system, computed depreciation in accordance with the system and properly maintained books and records. Taxpayer's substantial compliance argument to the Eleventh Circuit was that its actions satisfied the legislative purpose of simplifying depreciation systems and the election requirements are merely procedural details unnecessary to the legislative purposes.

The court distinguished substantial compliance cases cited by taxpayer, e.g. Tipps; Sperapani, by noting in those cases that taxpayers had made an election but failed to comply with a minor procedural detail. The court then held, 743 F.2d at 796, that the election requirements at issue were not mere procedural details but go to the essence of the regulatory scheme. The court noted that an election is binding, and this policy is furthered by requiring a clear manifestation of an election. In addition, a regulatory goal is for the Commissioner to know that an election has been made, and clearly informing the Commissioner of an election is essential. According to the Eleventh Circuit, the taxpayers in Knight-Ridder did not clearly manifest that an election was being made.

In Young v. Commissioner, 783 F.2d 1201 (5th Cir. 1986) the issue was whether there was an effective election under section 172 to carry forward NOL's. An irrevocable election is made by a statement indicating the section under which the election is made, information to identify the election, the period, and basis or entitlement for the election. Taxpayer argued there was an effective election as the tax return indicated that a 1976 N.O.L. would be carried forward to 1977.

The court found that the election requirement was of the essence of the statute; that is, a taxpayer must unequivocally communicate a binding election. The statutory intent was to require taxpayer when making the election, to assume the risk that a carryback would later prove preferable. See also Estate of Higgins v. Commissioner, 91 T.C. No. 7 (July 19, 1988).

Although a case such as Young seems to indicate that a court would not accord taxpayers the benefit of an implicit mass asset election, the case is arguably distinguishable for two reasons. First, central to the court's reasoning was that the election was irrevocable. Therefore, an explicit election was required. The mass asset election may be revoked with consent. Also, the mass asset election regulations specifically approve substantial compliance. Prop. Treas. Reg. § 1.168-5(e)(3)(v). What constitutes substantial compliance is, of course, a factual question. The court in Young even admitted that there could be substantial compliance absent literal adherence to the requirements of an irrevocable election, but taxpayers were unable to establish that they made an irrevocable election. 783 F.2d at 1206. Accordingly, in our view the important point for establishing an effective mass asset election is the presentation of facts demonstrating the consistent use of the method. When the election is not irrevocable, there is more leeway for taxpayers to establish the election.

Knight-Ridder is also arguably distinguishable from the instant situation. The case arguably requires a clear manifestation of an election. The Eleventh Circuit rejected the lower court's approval of an effective election which was based on taxpayer's consistent use of the class life system. Yet, as with Young, an important distinction is that the election at issue was binding; it could not be changed or revoked. Also, the regulations do not provide for substantial compliance, and the mass asset regulations provide for substantial compliance. Therefore, we believe that there are aspects of the class life election which led the court to reject the concept of an effective election. In addition, the Eleventh Circuit found that taxpayers had not clearly manifested their election, and based on cases discussed, supra, a court could find a clear manifestation of the mass asset election under the circumstances at issue here.

Our counter argument would be that taxpayers should be estopped from arguing that they have made the election because they were claiming losses upon disposition of assets as though they were not using mass asset accounting. They have neither made an explicit mass asset election nor applied to change from non-mass asset accounting to mass asset accounting. Because mass asset accounting must be consistently used for all tax purposes, claiming losses upon dispositions is evidence that mass asset accounting is not being used.

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